Global Fixed Income Strategy

Monthly report

Invesco Fixed Income

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Global macro strategy

Unlocking continued EM performance: Assessing US and China impacts

This year's big surprise has been the resilience of global growth, especially in the US, making a long-awaited recession unlikely. Emerging markets (EM) have also displayed remarkable growth resilience, despite restrictive domestic interest rates and China's wobbles. A global soft landing, including in the US, remains our baseline forecast and would be supportive of EM, in our view.

Nevertheless, uncertainty about US interest rates and slower Chinese growth have dampened sentiment toward EM. Going forward, we believe US interest rate cuts will be the primary catalyst for unlocking further EM performance, even in the event of a shallow cutting cycle. We view greater stability in China as another positive factor for EM. Though less impactful than US rate cuts, potentially easier Chinese monetary and fiscal policy in the second half of the year could provide a supportive backdrop for EM.

Impact of US policy on EMs

Key takeaway: The Fed continues to be the prime driver for EM markets. We are approaching the start of rate cuts, and even a shallow cutting cycle could benefit EMs. In the meantime, EM carry is attractive, in our view, and individual country dynamics could create total return opportunities.

Though the prospect of "higher-for-longer" US interest rates has receded since last December, the path of US growth and inflation, and, therefore, the path of US Federal Reserve (Fed) policy, continues to be the primary macro risk facing EMs.

Recently, solid US growth and stronger-than-expected US inflation data have led market participants to rethink the Fed's next steps and anticipate three to four interest rate cuts in 2024 versus their expectations of roughly double that back in December. Though probably less supportive than a deep Fed cutting cycle, a shallow Fed cutting cycle could still be positive for EM. Because the US federal funds rate serves as the risk-free anchor to the rest of the world, clarity on its future path would help lift the burden of uncertainty that EM central banks have been laboring under for some time.

As EM disinflation unfolded last year and into 2024, with a few upside inflation surprises, some EM policymakers began cutting policy rates, while safeguarding their credibility. In the face of continued US interest rate uncertainty, EM central banks largely demonstrated caution — at times either remaining on hold or reducing their pace of cuts to protect their currencies.

Looking ahead, the final stretch of EM disinflation could be hard to achieve, as the base effects from energy and supply shocks, which had the most influence on goods inflation, fade. Further disinflation will, therefore, likely need to come from services, which could prove challenging due to tight labor markets across EMs. Nevertheless, we have seen price pressures abate alongside growth resilience in EM. We believe the "early hiker" EM central banks can continue to lower rates while remaining restrictive enough to guide inflation toward their respective targets. As for the other EMs, especially in Asia, we believe the first Fed cut will likely open the door to cuts in the second half of this year.

Dispersion could create EM investment opportunities

Ultimately, we believe economic dispersion will drive the EM opportunity set. As we look at the rapid disinflation seen in Central and Eastern Europe over the last few months, we believe that individual country dynamics can drive returns, regardless of external outcomes, such as Fed decisions. For example, while growth in Poland and Romania is strong, growth in the Czech Republic and Hungary will likely be challenged. In those countries, we expect domestic growth considerations to take precedence in central bank rate decisions.

We could see a similar dynamic in Asia. The Thai and South Korean central banks may move next, having signaled an increased willingness to diverge from developed market central banks. Nevertheless, this policy may by guided or limited by movements in their respective currencies since currency stability remains a regional focus.

China impact

Key takeaway: China's newly announced economic policy targets reflect a broad continuation of last year, with efforts largely focused on promoting stability while seeking new sources of economic growth. Though not suggestive of broad stimulative measures, these policies offer a marginally more supportive environment for EMs.

China's National People's Congress recently announced its targets for 2024 growth, inflation, and fiscal and monetary policy. While largely in line with expectations, there were a few (albeit minor) positive surprises. These targets offer some insight into China's policy emphasis going forward.

China's 2024 annual growth target was set at "around 5%".[1] This is in line with our forecast of 4.7%. However, starting from a higher base in 2023, this target will likely not be easy to achieve without more policy support.

Nevertheless, the authorities' implementation plan, at least on its face, does not provide much hope for stimulus. The government announced a fiscal deficit target of 4.06 trillion yuan (3% of GDP) and a multi-year plan for an ultra-long government bond of 1 trillion yuan (around 0.8% of GDP). The headline numbers are identical to last year's targets, and the first issue of the ultra-long bond late last year. However, it appears that last year's extra funding was not fully utilized, so rolling the unused portion to this year could provide an additional fiscal stimulus of 0.4% to 0.8% of GDP this year, a modest advantage compared to last year to support growth.

The inflation target was set at 3%, which is an aspirational upper limit, in our view, rather than a realistic target. The budgetary report implied nominal GDP growth of 7.4%, leaving the implied GDP deflator at around 2.4%. There is an expectation that inflation will normalize from extremely weak levels, but we believe it will settle closer to 1% than the 3% level the authorities have put forward.

The tone of monetary policy remained similar to the tone conveyed in the December Central Economic Work Conference: Prudent monetary policy should be flexible, appropriate, and precisely targeted; growth of the M2 money supply and total social financing ("TSF", a broad measure of credit and liquidity in the economy) should be in line with economic growth and inflation targets; funding costs for the economy should be guided lower; and the exchange rate should be stable and maintained at a reasonable equilibrium level.

We expect the People's Bank of China to use its new Credit Department to ensure that credit is directed according to policy objectives, chiefly to the new growth engines referred to as "new productive forces": technology and the green economy and other areas of inclusive growth, elder care, and digital finance.

On the consumer side, the replacement of consumer goods, such as cars, goods, and manufacturing equipment, through "trade-in" programs was explicitly encouraged, although the details of trade-in subsidies were lacking. Also emphasized on the consumption side was support for the development of "new types of consumption" such as digital consumption, green consumption, and elder care consumption. This does not necessarily suggest demand side support but could mean providing more support to the supply side, with the hope that it fulfills untapped demand.

China's slow post-Covid recovery and transition away from a property-driven growth model will likely take time. During this process, maintaining stable growth at a reasonable level with sufficient policy support should provide a backdrop for a global soft landing scenario, especially for EMs that are closely intertwined with manufacturing supply chains in China and that depend on Chinese commodity demand.

1. Source for all People's National Congress policy targets: Bloomberg L.P., March 5, 2024.

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Interest rate outlook

USD: Neutral. Recent inflation and growth data have been more robust than anticipated by the market. US Treasury yields have adjusted upwards in response. We believe that, at current levels, US yields offer positive expected excess returns versus cash. However, uncertainty remains about when the upcoming rate cutting cycle will begin. We have revised our base case for the beginning of the Fed cutting cycle to June from May. The market will likely reward patience in adding to long US interest rate exposure.

Europe: Overweight. We are positive on European duration over the medium term. Yields have moved higher so far this year and present a buying opportunity, in our view. Over the coming year, we expect the European Central Bank (ECB) to reduce rates significantly, as inflation falls toward its 2% target and the region's economy continues to struggle from tighter financial conditions and a subdued global growth environment. The ECB rhetoric has become more dovish, and a cut in June now seems likely. We believe the market underestimates the pace and depth of rate cuts we expect over the coming two years.

China: Neutral. We have been expecting Chinese rates to be "lower-for longer", however, given the limited magnitude of moves by Chinese onshore bonds compared to US Treasury bonds, we maintain our neutral stance. After a series of interest rate cuts in various formats in recent months, the central bank governor stated in the press conference after the National People's Congress (NPC) that there is still room for China to cut the reserve requirement ratio (RRR) to release liquidity in the banking system. Even though there are upcoming RMB1trillion ultra-long special government bonds to be issued, as stated by the Premier during the NPC speech, we expect monetary policy to maintain sufficient liquidity to support large government bond issuance. From a technical perspective, we recognize the relatively crowded positioning in long China onshore rates, which may lead to asymmetrical market reactions toward data and news flow.

Japan: Underweight. After higher than expected wage growth, the Bank of Japan (BoJ) finally scrapped the Yield Curve Control (YCC) framework and hiked short term rates to 0.10% at its March meeting. Despite this dramatic change, Japanese government bond (JGB) yields were little changed over the last month. The reason for the mild reaction is that, while the decision to end YCC and negative interest rates was earlier than expected, it was not unanticipated, with most commentators expecting the policy change at the April or July BoJ meetings. More significantly, Governor Ueda signalled that the BoJ would maintain accommodative policy, tempering expectations for future rate hikes, and the BoJ committed to a pace of JGB purchases in April that was very close to its current pace of purchases. However, the acknowledgment that Japan has now reached a level of underlying inflation that is consistent with the BoJ's target implies that future upside inflation and growth surprises will likely have a bigger impact on the future path of policy. BoJ policy meetings are now live in a way they have not been for the last 19 years. Beyond short term interest rates, the slower pace of JGB purchases will likely still imply a growth in the free float outstanding going forward. The bar for the BoJ to step in to support the JGB market is now much higher than under the YCC regime. The private sector will likely increasingly determine the shape of the JGB curve, likely implying higher yields for 5-year to 20-year maturities. Looking forward, it appears probable that BoJ purchases will be reduced further, potentially leading to balance sheet contraction in 2025.

UK: Overweight. Recent data have increased the probability that the Bank of England (BoE) will start cutting rates this summer, potentially as soon as the June meeting. Core inflation slowed in February and employment and wage data point to an easing of labour market pressures. BoE hawks Haskel and Mann have recognized the improving inflation outlook, dropping their votes for higher rates at the March meeting. We should see further progress toward the inflation target in the second quarter, with a sharp fall in energy prices likely to push headline inflation close to target by the middle of the year. Short-term momentum also points to a likely decline in core inflation on a year-over-year basis. The start of the BoE cutting cycle should provide further downside in short-term yields. Long-term forwards might find more difficultly in falling, as growth expectations pick up and supply restarts in the new financial year. Gilt supply will likely reach a new record in financial year 2023/2024, leading to more upside for the term premium and tightening pressure on asset swaps.

Australia: Overweight. The Reserve Bank of Australia (RBA) dropped its hiking bias at the March meeting, reflecting softer domestic growth and slowing inflation. The market is now pricing 50 basis points of cuts in 2024, starting at the August meeting, with a total of 80 basis points of cuts to a terminal rate of 3.55% at the end of 2025.[2] This pricing is fair, in our view, albeit probably overly front loaded. The risk appears skewed to fewer cuts in 2024, relative to 2025. However, where the Australian yield curve stands out is the fact that beyond late 2025/early 2026, forwards re-steepen, leaving them to appear cheap relative to the long-term estimate of Australian neutral rates and relative to international peers.[3] Year-to-date, Australian rates have significantly outperformed US and European markets, largely due to revisions to the pricing of Fed, ECB and BoE cuts relative to a close to unchanged trajectory for the RBA. However, cross market valuations no longer look compelling on an outright basis, in our view, particularly in the front end of the curve. The steepness of the Australian yield curve relative to other markets now looks even more extreme. Consequently, curve flattener trades in Australia, relative to steepeners in the US and Europe look attractive, in our view.

2. Source: Bloomberg L.P. Data as of March 19, 2024.
3. Source: Bloomberg L.P. Data as of March 19, 2024.

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Currency outlook

USD: Neutral. We are broadly neutral on the US dollar in the short term. Given the outperformance of the US economy, and higher short-term rates than peers, the US dollar should remain supported in the near term. However, with the Fed still intent on rate cuts later this year, and valuations stretched, the case for overweight dollars is challenged. Our medium-term expectation is that the US economy will slow more than the market consensus, leading to a more protracted rate cutting cycle by the Fed, which should be more negative for the US dollar.

EUR: Underweight. We have a negative view of the euro over the medium term, based on our expectation of a more active ECB rate cutting cycle. That said, over a shorter time horizon, much depends on the path of the US dollar and the continued economic resilience of the US economy. If the US continues to grow at or around trend growth, while the ECB is reducing rates, we would expect the euro to struggle to make headway, despite the dovish pivot by the Fed.

RMB: Neutral. We believe recent policy measures announced to support local financial markets are marginally positive for the renminbi against the US dollar. However, the interest rate differential between the US and China is likely to keep some investors and exporters interested in the US dollar versus the renminbi. If the announced RMB2 trillion stabilization fund is put to work, the impact on capital flows will likely be beneficial for the renminbi's performance. However, we recognize that the April – May period typically sees higher demand for US dollars from local companies to pay dividends. We remain neutral on the renminbi against the US dollar considering its overall stability but could see slight pressure due to seasonality.

JPY: Neutral. The yen has weakened in recent weeks against the US dollar and euro, driven by widening interest rate differentials, as the US and European rates markets have repriced expectations of interest rate cuts in the face of buoyant risk sentiment and resilient economic data. In addition, weaker Japanese data have tempered expectations for an imminent rate hike from the BoJ. Current yen valuations look relatively cheap when compared to the level of interest rate spreads, as the USD/JPY and EUR/JPY exchange rates are close to their highs, but interest rate spreads are still near the October wides. Nevertheless, until economic data deteriorate substantially, leading to a rapid cutting cycle from the Fed and ECB, it is hard for us to expect substantial yen outperformance.

GBP: Neutral. The British pound has been one of the best performing developed market currencies year-to-date, helped by better risk sentiment, improved domestic economic data and the repricing of rate cut expectations, reinforcing the pound's status as a relative high yielder. However, the upside for the pound going forward looks more limited. There are less than 70 basis points of cuts now priced into the UK yield curve for this year, limiting the scope for interest rate differentials to shift in the pound's favor. Growth expectations have picked up already and further upside might be more limited. In addition, the level of UK growth remains lacklustre on a relative basis. If global growth picks up substantially it is hard to see the pound outperforming more cyclical currencies like the Australian dollar or Norwegian krone. Alternatively, lower growth would likely see the pound suffer versus the US dollar and Japanese yen.

AUD: Neutral. Australian dollar valuations look attractive relative to interest rate differentials and the terms of trade. However, the path for Australian dollar outperformance remains a relatively narrow one. The Australian dollar probably requires a combination of a dovish Fed, a stable-to-hawkish RBA and a recovery in growth outside the US, particularly in China, to meaningfully rally against the US dollar. There are tentative signs that global growth is picking up and signs that Chinese stimulus efforts are building, but as yet, these trends are nascent and continue to be overshadowed by strong US growth, which keeps pushing back expectations of Fed easing.

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Global credit strategy

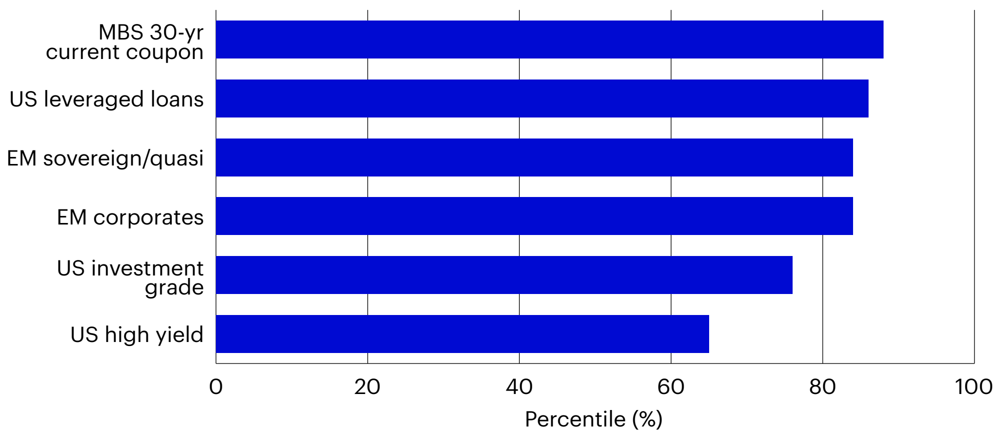
Agency MBS stand out as attractive

This section highlights the views of Invesco Fixed Income's credit analysts across a broad range of fixed income assets managed by Invesco.

As yields have climbed to levels not seen in over 15 years, it is not surprising that fixed income has garnered significant attention from investors lately. With yields this high and given our view that most central banks have completed their hiking cycles and will begin to reduce policy rates this year, forward looking returns certainly seem appealing. But in this environment, where should a multi-sector manager allocate a marginal dollar within fixed income?

While it is true that yields are historically high across fixed income sectors (Figure 1), a large portion of the increase has been a rise in risk-free rates. In general, the excess spread over US Treasuries that investors are paid for various risks (liquidity, ratings migration, default, etc.) has shrunk meaningfully over the past year. However, there is still at least one major part of the bond universe where risk compensation is generous, in our view.

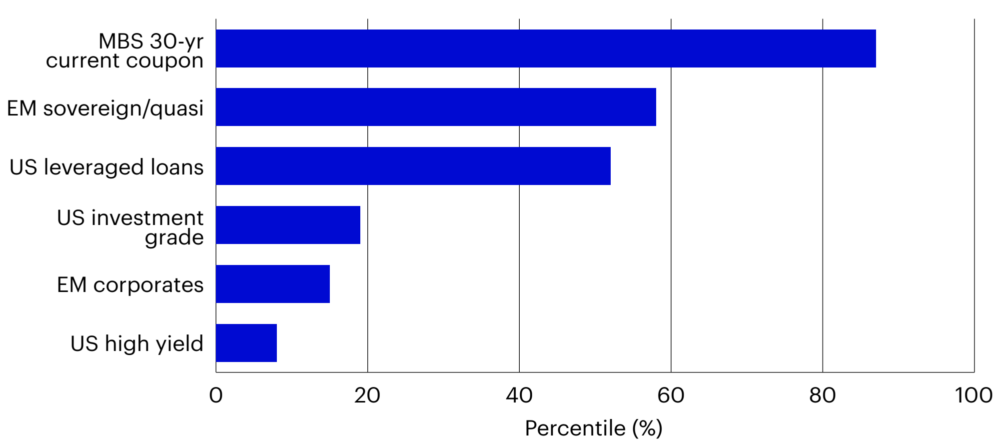
Figure 1: Yields are historically high across fixed income
Yield (percentile, last 20 years)



Source: JP Morgan. Data as of Feb. 29, 2024.

30-year current coupon, agency mortgage-backed securities (MBS) stand out among other large sectors in terms of providing a historically high level of spread and yield (Figures 1 and 2). While there is virtually no credit risk embedded in agency MBS, the product is exposed to interest rate volatility. Agency MBS have an embedded prepayment option, so large moves up or down in rates can be detrimental to investors. Production coupon MBS are most exposed to this feature, given their pricing closest to par.[4] This explains why the product still provides a high level of spread, as the extraordinary move in policy rates experienced in 2022 and 2023 resulted in subsequent high levels of interest rate volatility.

Figure 2: Agency mortgage-backed securities stand out
Spread (percentile, last 20 years)



Source: JP Morgan. Data as of Feb. 29, 2024.

4. Production coupon refers to the MBS coupon currently being issued in the market. Whereas "current coupon" is the interpolated coupon for a par-priced MBS, "production coupons" are actual coupons issued in the marketplace and are typically priced near par (both above and below).

Nevertheless, we view this as an opportunity. With growth near trend and inflation declining, we could see the range for interest rates narrow. In what we view as the most likely scenario, the Fed should begin reducing its policy rate in June with a total of three to four cuts by the end of the year. We think this should result in a benign environment for interest rate volatility and consequently agency MBS. Other benefits of this sector are its high degree of liquidity, and scalability for managers through the use of TBA contracts.[5]

The final question we must ask is how could we be wrong? From a macroeconomic perspective, perhaps the most salient risk would be if inflation remained stubbornly above the Fed's 2% target. A delay, or outright removal of projected Fed cuts would likely be negative for MBS and fixed income in general. Conversely, if economic growth declined significantly, requiring large Fed rate cuts, that could generate negative excess returns, although total returns should be positive. Finally, there is a US presidential election this November, and if history is a guide, the outcome could result in sizable moves in US Treasury yields.

As is usually the case in markets, risk must be retained in order generate healthy returns. So, why not get paid a decent price for bearing that risk? We think current coupon, agency MBS provide a good yield at a good value.

5. TBA contracts are "to-be-announced" and are essentially the forward market for fixed rate agency MBS coupons.

Panelists

Stuart Edwards
Portfolio Manager

Mark McDonnell
Macro Analyst

The bottom line: Global asset allocators are watching central banks and labor markets

We speak with Stuart Edwards and Mark McDonnell about the macro themes driving their multi-sector asset allocation decisions.

Q: Stuart and Mark, what is your area of focus in fixed income?

Our approach tends to be at the flexible end of fixed income strategies. We invest across rates, EM and credit — both investment grade and high yield. We start with a top-down macro view, which is continually evolving; if the experience of recent years is anything to go by, the lesson is to not take anything for granted. We continuously question our views and the prevailing market consensus. We lean heavily on our macro strategists (emerging and developed market), tapping into the analytical resources of the wider Invesco Fixed Income platform and external sources to understand the risks and opportunities around key macro themes.

Q: Stuart, what is your current thinking on the macro environment?

It's both complex and, as a student of economics, fascinating in equal measure. I have a lot of sympathy with the soft-landing narrative and might even go as far to say that it could be a reasonable base case. But there are risks which I believe to be asymmetric and skewed to the downside. While it is true that the widely held consensus view in early 2023 for a US recession ended up wide of the mark, I am very much in the camp that policy lags are still variable — both short and long — and all the more unpredictable in this post-pandemic world. The puzzle for many is why the most aggressive hikes in 40 years didn't bite more, as theory would dictate. In practice, there have been winners and losers: Interest rate sensitive sectors, such as residential construction, clearly took a hit and are now in the process of recovering. On the other hand, those economic agents (consumers and businesses) that were able to term out their debt and borrow at low rates in the aftermath of the pandemic and deposit at higher short-term rates have clearly benefited. But at some point, that debt needs to be refinanced. Commercial real estate risks are still out there — some visible, some not. It may not be a systemic risk but rather a slow bleed, and one that impairs the lending capacity of small and regional banks. In that regard, I find it quite telling that small and medium-sized business optimism in the US is still quite weak, according to the NFIB survey of small businesses.

Q: What themes are you focused on going forward?

The state of the US labor market and whether the inflation outlook is conducive to meaningful Fed easing will be critical going forward, in our view. While not necessarily my base case, there is a material risk that inflation remains a bit sticky at a time when the economy and the labor market weaken. There are some signs of cracks in the latter and that needs to be watched, as a deterioration may not be linear and could undermine the hope that aggregate real incomes can recover from here.

Q: Mark, what are your big picture thoughts on the macro outlook for the US, eurozone and the UK, as they relate to growth and inflation?

Real gross domestic product in the UK and eurozone has only just surpassed its pre-Covid peak. In contrast, US GDP is nearly 10% higher than its pre-Covid level. Of course, there are many explanations for this. One explanation is the size and nature of US fiscal support. Spending more money certainly helped and supporting households via stimulus checks versus furlough programs created churn that reallocated workers to the new and fast-growing sectors of the economy. This, alongside a relatively flexible labor market appears to be a factor boosting US productivity.

A second, equally plausible, explanation is the differing nature of the inflation shock. Back in 2022, the ECB was initially cautious to hike — citing cost-push inflation rather than (US-style) demand-pull inflation. As European inflation continues to fade and the recovery remains somewhat elusive, I can't help but think the ECB's initial caution might be justified. At the very least, this tells me that policy in the UK and the eurozone is tight and neutral interest rates are unlikely to have moved. Until the BoE and ECB reverse course, any recovery is likely to be muted, which should help bring inflation down — albeit with a lag that reflects Europe's labor rigidities.

In the US, we can't refer to a recovery, as it never experienced a slowdown. As such, there is a bigger question mark as to whether something more structural is at work — no doubt aided by exceptionally generous fiscal policy. Far from being settled, the question of US neutral interest rates is likely to garner a lot of attention over the coming quarters.

Q: Drilling down a bit further, are there any particular macro risks that stand out to you?

A soft landing remains a plausible base case. I do, however, worry what impact emotions will have on the rate cutting cycle. Central banks are meant to be rules-based technocratic institutions. In reality, humans are emotional, setting policy involves a large amount of discretion — and central bankers worry about their legacy. All developed market central banks are well versed in the mistakes of Arthur Burns and achievements of Paul Volcker. Better to keep policy too tight and cut aggressively than loosen too quickly — only to reverse course further down the line. In that sense, central bankers are still more sensitive to upside inflation risks than downside growth risks. So long as that view is maintained, I can't help but think the real risk is a policy mistake (i.e., keeping policy tighter for longer) that exacerbates downside growth risks — and not upside inflation risks.

Q: Stuart, how do you favor expressing these views from an investment standpoint?

Given the aforementioned views, I think it is fair to say that we have become more incrementally cautious on risk, given valuations, not just when it comes to flexible or multi-asset strategies, but also in our high yield and investment grade strategies. Over the last year or so, we have reduced credit risk and increased our focus on government bonds, especially UK gilts and European duration more broadly, where we have tended to see better value. The US Treasury market, by contrast, has often presented greater valuation challenges due to the yield curve inversion, as well as the more resilient growth picture. The bottom line is we feel that duration may become more attractive if the stars align and the economic outlook materially weakens.

Q: Where else do you favor taking risk?

We still favor credit, but over the past year we have tilted toward financials where we have tended to see better value, especially in the wake of the Credit Suisse-induced volatility in Europe and the regional banking crisis in the US. In the non-financial corporate sector, we have favored shorter-dated investment grade where we can pick up some enhanced yield versus government bonds, especially in sterling. In short, our risk stance is more cautious than it was in 2021 and 2022. That said, we still like selective EM local debt. The disinflation process in EM countries continues and is arguably more entrenched than in some developed markets, including the US. Hence, real yields still look attractive, in our view, in some of these markets.

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